

CAUTIOUS CREDITOR®

September 2000

PERFECTION OTHER THAN BY FILING UNDER REVISED ARTICLE 9

Revised Article 9 of the Uniform Commercial Code (UCC) will become law in Indiana (and most other states) on July 1, 2001. Recent issues of the *Cautious Creditor*® addressed various aspects of Revised Article 9 and its impact on secured transactions. Last month's article discussed one method of perfection under the new statute: new procedures for filing financing statements. This issue addresses three other ways to perfect security interests in certain types of collateral under Revised Article 9: automatically, by possession and by control.

Automatic Perfection

The UCC already provides for automatic perfection of purchase money security interests in consumer goods. Revised Article 9 applies automatic perfection to other transactions, including assignments of health-care-insurance receivables to the health care provider and the sale of promissory notes and payment intangibles. Thus a secured party can purchase promissory notes in a securitization transaction and leave them in the hands of the seller for servicing, and its rights in the promissory notes will be protected in the seller's bankruptcy without filing a financing statement. Creditors should be aware, however, that automatic perfection does not apply when an obligation is secured by a promissory note or payment intangible, as opposed to a sale of such property.

There is also automatic perfection of security interests in supporting obligations (such as letters of credit and guaranties) that enhance the value of collateral when a security interest in the collateral is perfected. For example, perfection of a security interest in accounts receivable automatically perfects a security interest in rights under a standby letter of credit supporting the receivables.

Perfection by Possession

A security interest in an instrument can be perfected only by possession of the instrument under existing Article 9. Revised Article 9 allows perfection of security interests in instruments either by possession or by filing. Although perfection by filing will protect the secured creditor against the debtor's trustee in bankruptcy, Revised Article 9 makes perfection by filing subordinate to the interest of a secured party who perfects by possession. Perfection by possession also affords greater protection against the claims of a holder in due course.

Revised Article 9 also modifies the existing method of perfecting a security interest in collateral that is in a third party's possession. Under current law, a secured party can perfect its security interest by giving notice to the third party in possession. Revised Article 9 requires notice *and* an acknowledgment from the third party that it is holding the collateral for the secured party.

Perfection by Control

The concept of perfection by control was introduced into existing Article 9 several years ago in connection with revisions to Article 8 of the UCC regarding investment property. Revised Article 9 extends control as a method of perfection to deposit accounts, electronic chattel paper and letter-of-credit rights.

One of Revised Article 9's most significant changes is to bring non-consumer deposit accounts within its scope as original collateral. Under current law

in most states, deposit accounts are excluded from Article 9; therefore the perfection of security interests in deposit accounts is governed by non-UCC common law. Under Revised Article 9, a security interest in a deposit account as original collateral may be perfected only by the secured party taking control of the deposit account. Filing a financing statement will not perfect a security interest in a deposit account as original collateral. The application of uniform UCC rules to security interests in deposit accounts should provide more certainty in these types of transactions and make these transactions less expensive.

Under Revised Article 9, a secured party obtains control of a deposit account if (1) the secured party is the depository bank, (2) the account is placed in the name of the secured party, or (3) the depository bank enters into an agreement with the secured party that the depository bank will comply with the secured party's instructions as to funds in the account without further consent from the debtor. The debtor may retain the right to use the account without destroying the secured party's control, but the secured party will not be perfected if the future exercise of its control requires the debtor's consent.

For electronic chattel paper, control requires a unique marking of the electronic chattel paper that identifies the secured party (according to the drafting committee's official comment, this is the functional equivalent of possession of tangible chattel paper). For letter-of-credit rights, control means that the issuer of the letter of credit must consent to the assignment to the secured party of the proceeds of the letter of credit under Article 5 of the UCC (but this does not give the secured party the right to draw under the letter of credit).

Comment

Under Revised Article 9, security interests in certain types of collateral can be perfected in more than one way. The choice of perfection methods often will determine the priorities of competing security interests in the same collateral.

For example, a security interest in an instrument may be perfected by filing a financing statement or by possession of the instrument. Either method protects the secured party against the debtor's trustee in bankruptcy, but perfection by filing does not protect the secured party against a subsequent secured party who perfects by taking possession of the instrument (unless the second secured party knows that its security interest violates the rights of the first secured party). Similarly a security interest in investment property or a letter-of-credit right may be perfected by filing a financing statement or by control. However a secured party who perfects only by filing is not protected against a subsequent secured party who perfects by control, even if the second secured party knows of the prior perfected security interest. The priority rules become even more complicated when competing security interests are perfected by different methods of control, as in the case of deposit accounts.

The decision whether to depend solely on filing or some other appropriate method of perfecting a security interest in specific collateral often depends on the creditor's level of confidence in its debtor. However the cautious creditor should be aware that the priority of its security interest could be affected by its chosen means of perfection.

For more information in this area, please contact **Peggy J. Naile** at (317) 236-2475, Internet: naile@icemiller.com.

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